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SENSITIVE

STATE FOR EEB (NELSON), EEB/OMA (SAKAUE, WHITTINGTON),
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TREASURY PASS TO FEDERAL RESERVE
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SUBJECT: WILL A CREDIT CRUNCH IMPEDE GERMANY'S RECOVERY?

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¶1. (SBU) SUMMARY: A heated debate is again raging over whether or not the German economy is experiencing a credit crunch. Politicians and businesses complain how hard loans are to get, and claim that tighter credit threatens recovery in Europe's largest economy. Others say overall credit volumes have held up, and point to weaknesses in the wider economy as the culprit of irregular lending activity. The picture is in fact mixed: lending is more restrictive in some respects, but the situation has not yet become a crisis. This could soon change, however. German banks are struggling under the weight of illiquid assets, and government rescue schemes are unlikely to repair the financial sector's fundamental weaknesses. Furthermore, Basel II requirements and EU Commission state-aid rules are putting pressure on banks to build up their capital base and restrict lending. Germany's financial sector appears ill-prepared to contribute meaningfully to economic recovery. END SUMMARY.

CRYING WOLF?

¶2. (SBU) Much like December 2008 (REF A), key political figures are warning that tight credit conditions could jeopardize recovery from Germany's worst post-war recession. Lamenting a credit crunch, Chancellor Angela Merkel of the Christian Democratic Union (CDU) threatened to "have a serious word with the banks" if loans did not increase. The Social Democratic Party (SPD) Chancellor-candidate Frank-Walter Steinmeier's freshly tapped economic advisor Harald Christ said banks' reluctance to lend to small- and medium-sized enterprises (SMEs) was endangering recovery. Finance Minister Peer Steinbrueck (SPD) told banks they had a "duty" to lend out funds they had acquired at historically low rates from the European Central Bank (ECB). Much to the irritation of Bundesbank President Axel Weber, Steinbrueck even suggested the Bundesbank consider buying commercial paper to get credit flowing. The Federation of German Industry (BDI) says its members -- many of which are large, industrial concerns -- are finding it increasingly difficult to obtain loans. To assess the situation, Steinbrueck will

convene a meeting with banks and businesses on September 1, 2009 in Berlin.

¶3. (SBU) Others are not so sure. Gerhard Schorr, Director of the Association of Mutual Banks in Baden-Wurtemberg, described an "unrealistic expectation that everybody has to receive a loan during a recession, while banking supervisors simultaneously require banks to exercise prudence in granting credit." According to Michael Schroeder of the Center for European Economic Research (ZEW), "Both the absolute level and the rate of growth of credit volume compared to the previous year contradict talk of a credit crunch in Germany." What is really going on?

LONELY IN THE MIDDLE

¶4. (SBU) European Central Bank (ECB) data indicate that the volume of German financial institutions' loans to Eurozone non-financial corporations has in fact fallen slightly, to 931.6 billion euros in June, down from 937.1 billion euros in May. Still, banking industry representatives told us the real concern was the type of credit that banks were currently issuing, not the overall volume. Financing with a maturity "beyond five years" is relatively harder to get, according to Carsten Gross, Director of the Association of State Banks. Long-term lending (more than five years) increased by just 2.2 percent in the first quarter of 2009 compared to the previous quarter, while medium-term lending (between one and five years) increased by 8.8 percent, and short-term lending (under a year) grew by 11.9 percent. So-called "syndicated bonds," wherein several banks form a consortium to lend a relatively large sum (often to large companies), are far less available today, said Gross. In contrast, credit to domestic enterprises and self-employed persons expanded by 5.4 percent

on a year-on-year basis in the first quarter of 2009. Bernd Brabaender, Managing Director of the Association of German Private Banks, agreed that large loans to big companies were down. He added, however, that the smallest of the SMEs, which often lack collateral, are also starting to have problems. Thomas Keidel, Director of the Association of Savings Banks, told us that depending on the region, savings and cooperative banks are now providing 50-80 percent of credit to companies. Companies supplying the domestic market, he added, are actually finding it easier to get loans.

¶5. (SBU) Recent studies substantiate these views. The Ifo Institute found that larger companies in Germany are having difficulty obtaining loans for two reasons: 1) they are more affected by the recession due to their stronger export focus, which in turn makes banks more cautious about lending to them; and 2) large companies are more often clients of commercial banks and state banks, which are currently restrictive in their lending. Large, manufacturing firms in the automotive, chemicals and machinery sectors are feeling the pinch the most.

¶6. (SBU) According to another study by the German Chamber of Commerce (DIHK), tighter credit conditions and higher credit costs are indeed affecting some companies. Almost two-thirds of those surveyed, however, said they had experienced no problems; some said credit conditions had actually eased. The current lending situation, while abnormal, is actually "not as bad" as it was during the economic 2002-2004, when GDP shrank by far less than this year's expected 6 percent contraction. DIHK sees problems on the horizon, however. So far, German SMEs, which are normally self-financing and therefore have less need to borrow, are starting to exhaust reserves because of the downturn. Many now need loans just to stay afloat.

BAD, BAD BANK

¶7. (SBU) While Germany's weak economy is a major factor

affecting the credit-worthiness of borrowers, other factors are also influencing bank's willingness to lend. A leaked report from the bank regulator Bafin estimates German banks still have as much as 800 billion euros in hard-to-value assets on the books, with a major share held by the ailing state-owned banks (though the Finance Ministry put the actual amount of truly "toxic" paper at only around 230 billion euros). Banks are restricting certain types of lending as they build up provisions against expected future losses. According to Moody's, German banks are thinly capitalized, with little more than 2 percent of equity supporting assets. (NOTE: Under Basel II, banks developing their own bespoke risk measurement systems may maintain lower risk capital requirements.)

¶8. (SBU) German lawmakers recently approved a "bad bank" plan to help rid banks of their toxic assets. The plan is actually a revision of the Financial Market Stabilization Act, which created the 480 billion euro bank rescue fund ("Soffin"). According to Svena Brinkmann of the Finance Ministry's National and International Financial Market and Monetary Policy Division, the new plan allows banks to create institute-specific, special-purpose vehicles (SPVs), where banks may voluntarily park assets for up to 20 years (REF B). The plan also envisages a separate "consolidation model" for state banks, covering the transfer of risk positions and business divisions to liquidation institutions at the federal or state level.

¶9. (SBU) The banks are not impressed. Bernd Brabaender told us that while Germany's private banks officially welcome the plan, few will sign on. The scheme has onerous conditions, such as the 10 percent "haircut" banks take when transferring assets to the SPV. Banks must also cap executive salaries at 500,000 euros. Most of all, there is not a genuine transfer of risk. As a result, only the sickliest of banks -- perhaps

WestLB -- will sign on. (NOTE: Commerzbank and Postbank recently declared they would not participate.) Others will merely lumber forward, zombie-like, weighted down by toxic assets.

¶10. (SBU) Furthermore, the German government and Bundesbank have resisted calls to apply U.S.-style "stress tests." Instead, an EU-wide assessment is underway, with aggregate results due in the fall. Results for individual banks will not be made public, so the exercise may raise more questions than it answers. Jens Conert, Division Head for Banking, Ministry of Finance, told us the three participating German banks were "not representative of the German banking sector," though he could not reveal their names.

OUTSIDE FORCES

¶11. (SBU) Meanwhile, German banks must contend with restrictions from beyond Germany's borders. Basel II requires banks to set aside additional capital when corporate clients are downgraded. Franz-Christoph Zeitler, a member of the Bundesbank's Board of Directors, recently warned of a "dramatic downgrading of entire asset categories" in 2009-2010. Recognizing the tight spot German banks are in, Finance Minister Steinbrueck tried to convince his EU colleagues to ease Basel II rules at the recent EU Finance Ministers meeting. He was unsuccessful.

¶12. (SBU) A further complication is EU state-aid rules. The EU must approve certain "stabilization measures without specific time limits, such as risk shields and capital injections," explained Jens Conert. An example is the state-owned WestLB. The EU Commission tied approval of a 5 billion risk shield for WestLB to a requirement to halve total assets. Another example is the Commerzbank-Dresdner Bank merger, backed by substantial state aid. The combined bank is shrinking its balance-sheet from 1.1 trillion euros to just 625 billion euros -- less than the pre-merger

Commerzbank alone. As Bernd Brabaender explained, banks are caught between conflicting imperatives: the government wants them to lend, but the Commission wants them to consolidate their balance sheets.

COMMENT

¶13. (SBU) With big, long-term loans relatively hard to come by, credit conditions in Germany are far from normal. The increased difficulty small companies are now having obtaining credit is another worrying sign, especially since many believed SMEs would weather the financial crisis better than most. Current credit conditions are due, in part, to weakness in the overall economy, which diminishes the quality as well as quantity of credit demanded. As for the supply of credit, Germany's financial sector is burdened with problem assets and counter-cyclical requirements that deter lending.

¶14. (SBU) Still, it is probably a stretch to call the current situation a "credit crunch." Rather, the real concern is not so much the present, but the future. With no fix for the sector's problems on the horizon, banks have little incentive to increase lending. The fact that long-term credit is relatively hard to get is a sign of future uncertainty. Absent serious efforts to restore the financial sector to health, strong economic growth will remain elusive. In turn, slow growth (or no growth) will further weaken banks' balance sheets, with a negative feedback loop strangling hopes for recovery.

¶15. (U) This cable was coordinated with ConGen Frankfurt.
Bradtke